MEMORANDUM

TO: File No. S7-41-11
FROM: Nathaniel Stankard
DATE: September 30, 2013

RE: Meeting with Better Markets

On September 30, 2013, Mary Jo White, Chair; Lona Nallengara, Chief of Staff; Nathaniel Stankard, Deputy Chief of Staff; John Ramsay, Acting Director, Division of Trading and Markets; Jim Burns, Deputy Director, Division of Trading and Markets; Norm Champ, Director, Division of Investment Management; and Craig Lewis, Director, Division of Economic and Risk Analysis met with Dennis Kelleher, President and CEO, Better Markets; Stephen Hall, Securities Specialist, Better Markets; and Katelynn Bradley, Attorney, Better Markets.

During the meeting, the parties discussed the issues related to the Volcker Rule presented by the Better Markets representatives in the attached document.

Effective Implementation of the Volcker Rule's Limited Ban on Proprietary Trading

Presentation to SEC Chair White
September 30, 2013

Better Markets' 5 VR Comment Letters

- November 5, 2010: Key principles addressed
- February 13, 2012: Response to 4 agencies
- April 16, 2012: Response to CFTC, but response addressed to all agencies
- June 19, 2012: Response to SEC on entry of market makers & metric to test for risk mitigating hedging
- January 8, 2013: Submission of report of Goldman's proprietary trading around the VR

<u>Many important topics/issues</u>

- All covered in detail in the Better Markets' comment letters
  - Won't go over everything in this meeting
- Focus today on the reportedly key issues still outstanding
  - But, many other equally key issues (like <u>conflicts of interest</u> & econ analysis) which are addressed in the comment letters & should be included in the final rule

Distortions & baseless claims about the Volcker Rule

- Much has been said about the VR & much of it is inaccurate & unsupported by evidence/data
  - Narrow in application and limited in scope
  - Prohibition itself narrowly targeted at specific, high risk behavior
  - Does not prohibit proprietary trading
    - Only at a handful of the largest banks
    - Prop trading will continue robustly by other existing and new market entrants (addressed 6/19/12 CL)

If Paul Volcker himself was distorted as much as the rule named after him

He’d look like this

Banks making claims without providing <u>readily available evidence = it does not exist</u>

- The handful of banks subject to Volcker Rule have made numerous claims about VR deficiencies, but have not provided supporting evidence
  - Even though they have unique privileged access to that evidence: their own trading data
  - And, a unique incentive to provide it (if it exists): a rule that conforms to their requests
- Under such circumstances, the only reasonable presumption is that the data does not support their claims, which must be disregarded

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"All the News That's Fit to Print"

The New York Times

Late Edition

VOL. CLVII.. No. 54,437 NEW YORK, THURSDAY, SEPTEMBER 18, 2008

NEW PHASE IN FINANCE CRISIS

Show, don't tell.

That approach is often the best way to explain a complex subject — and persuade people of your case. But it seems to have been underdeployed in the letters submitted to regulators on the Volcker Rule, which attempts to stop proprietary trading at financial firms that enjoy a government backstop. An unusually large number of comment letters had been filed by Monday, the deadline for responding to a draft of the rule that was outlined in October.

Both supporters and critics have largely relied on arguments that — while sophisticated and technical — are merely theoretical. The letters tend to lack the sort of numerically supported real-world examples that could shed more light on the issue.

Take JPMorgan Chase's 58-page letter, which is mostly critical of the draft rule. It contained several assertions in support of its case that the rule "would have serious, adverse effects on our ability to manage our risks and address the needs of our clients, and on market liquidity and economic growth."

While it does make plenty of detailed references to specific businesses at JPMorgan, the arguments lack quantifiable references. One segment of the JPMorgan letter does stand out. The bank contextualizes an argument in an actual event. In it, JPMorgan describes the moves it made during the financial crisis to manage an inflow of over $100 billion in deposits — and expresses doubts about whether it could make the same responses under the Volcker Rule.

Letters from Credit Suisse, Morgan Stanley and Bank of America also had few fleshed-out examples from their own operations.

Real-life numbers could inform a key debate over banks' market-making business, in which they hold inventories of securities to facilitate customer trades.

One of the main arguments against the Volcker rule is that legitimate market-making would be classified as trading and have to stop. Some market-making revenue is attributable to fees and other costs borne by customers, but some is from price movements in the securities the banks are holding – a source that might be classified as trading under the Volcker rule.

It would be helpful for banks to break out these sources in their comment letters, said Kurt Schacht, managing director of the CFA Institute, an organization that promotes ethics and standards in the financial industry.

"It could show the extent to which market-making tips into proprietary trading," he said. But in their comment letters, several banks said attempts to break out client-specific revenue would not reflect how market-making works. At the same time, Morgan Stanley said that that market-makers "will have substantial revenues from market movements of their principal positions."

Knowing how substantial might help explain why the banks have spent so much time and money fighting the Volcker rule.

Just one example of a repeated <u>industry claim without data or support</u>

- Claim: Must maintain large inventories of corporate bonds (prop positions) or there will be illiquidity in corporate bond market
- Where data: uniquely in possession of banks
- Data provided: None
- Claim contradicted by independent data: Detailed in comment letters: 4/16/12 & 2/13/12

Effective implementation will not reduce market liquidity (1/2)

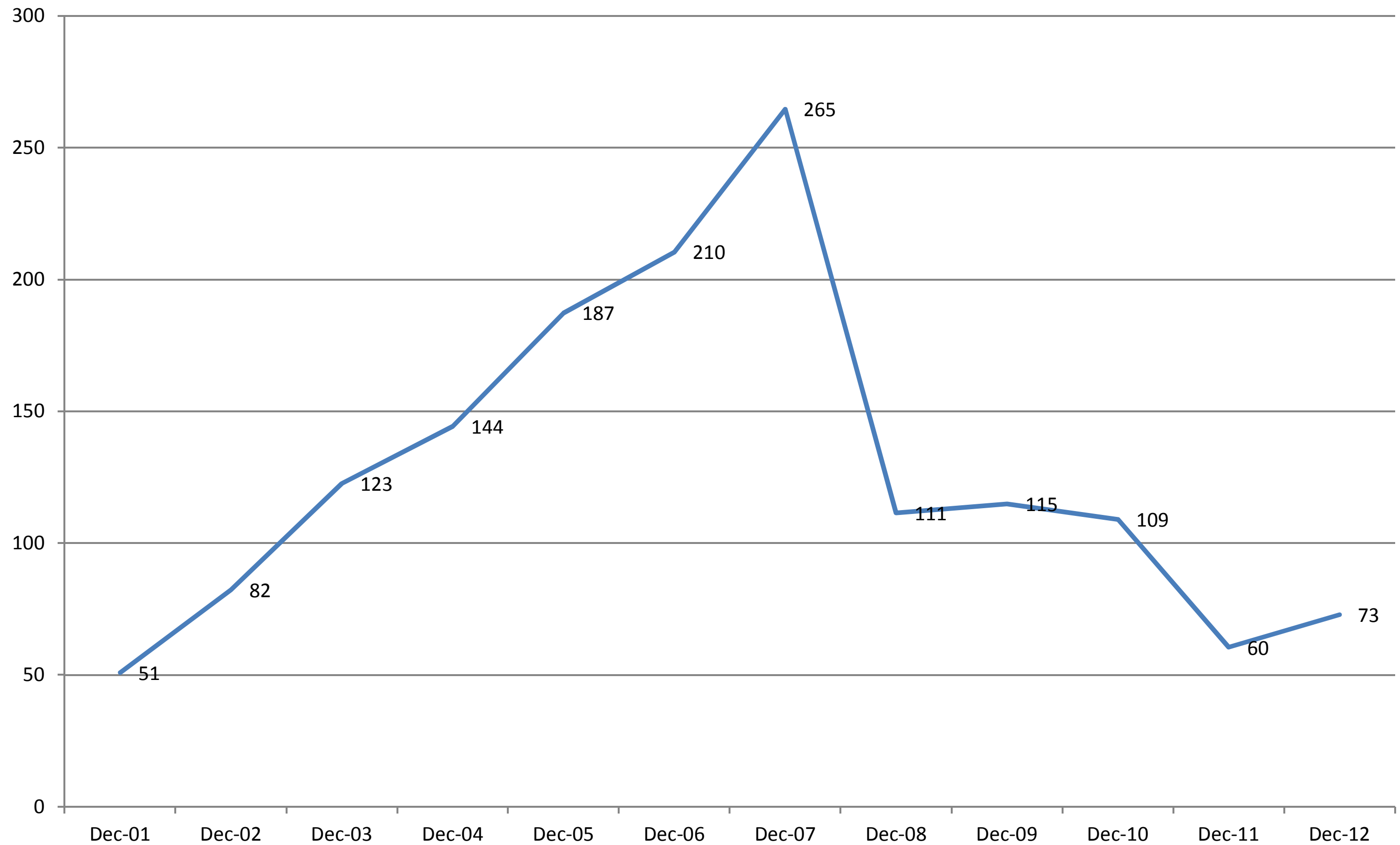
- **Post-TRACE -- i.e. since 2002 -- banks have not held significant inventories of infrequently traded bonds – they act as brokers**

  - H. Bessembinder and W. Maxwell (2008). Transparency and the Corporate Bond Market. Journal of Economic Perspectives, Volume 22, Number 2, 217-234
  - M. Goldstein et al. (2007). Transparency and Liquidity: A Controlled Experiment on Corporate Bonds. The Review of Financial Studies. Volume 20, Number 2, 235-273.

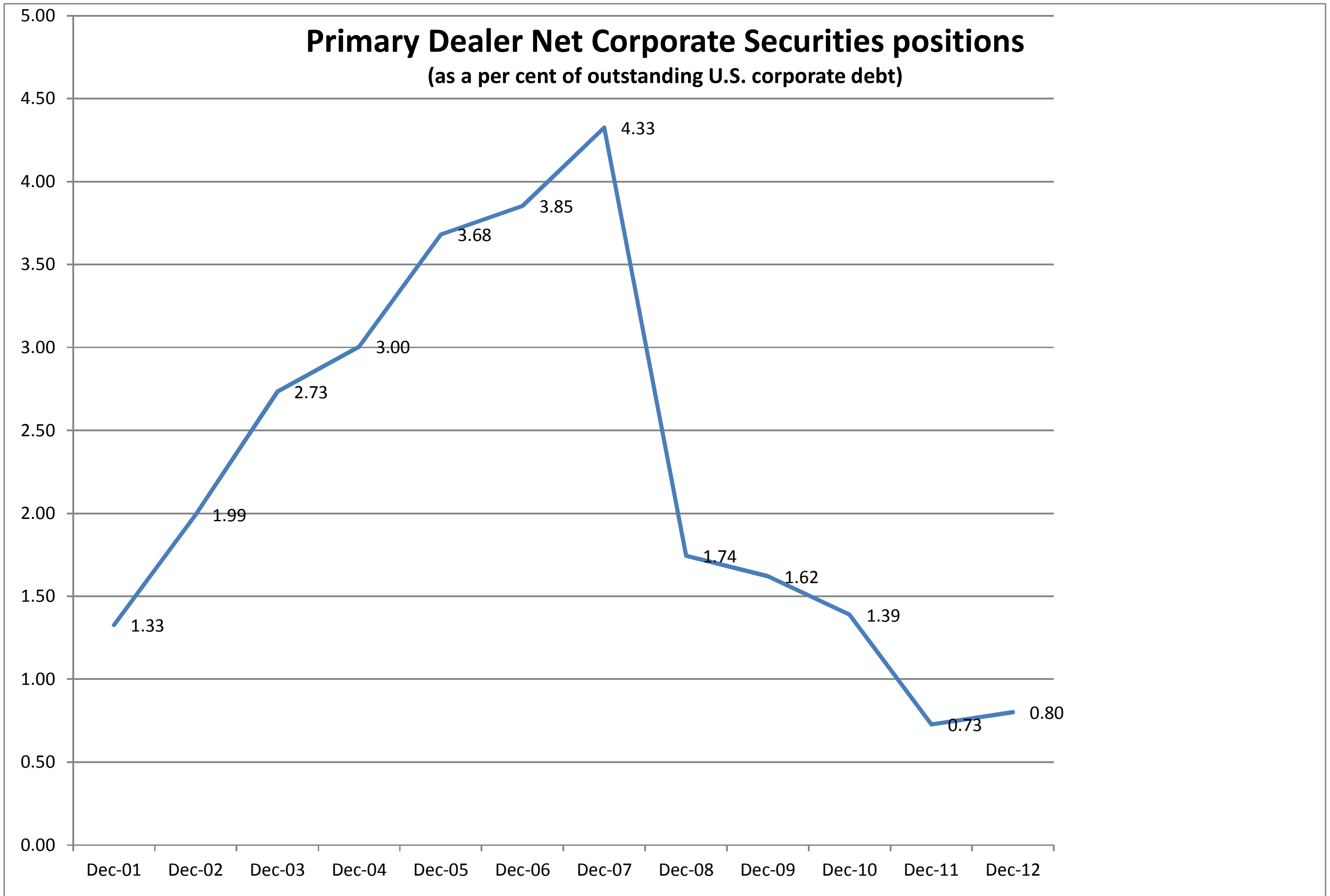
Effective implementation will not reduce market liquidity (2/2)

- **And, large swings in primary dealer inventories have <u>not</u> moved OTC bid/ask spreads in the predicted manner, i.e., no impact on liquidity**
  - If inventories are important to liquidity, trading costs should rise when inventories decline
  - Inventories rose sharply, 2001-2007, but the bid/ask was unaffected
  - Inventories declined sharply since 2007, but after the 2007-2009 sell-off, the bid/ask reverted to pre-crisis levels

Primary Dealer Net Corporate Securities Positions
($B)



Source: Federal Reserve Bank of New York



Source: Federal Reserve Bank of New York and SIFMA

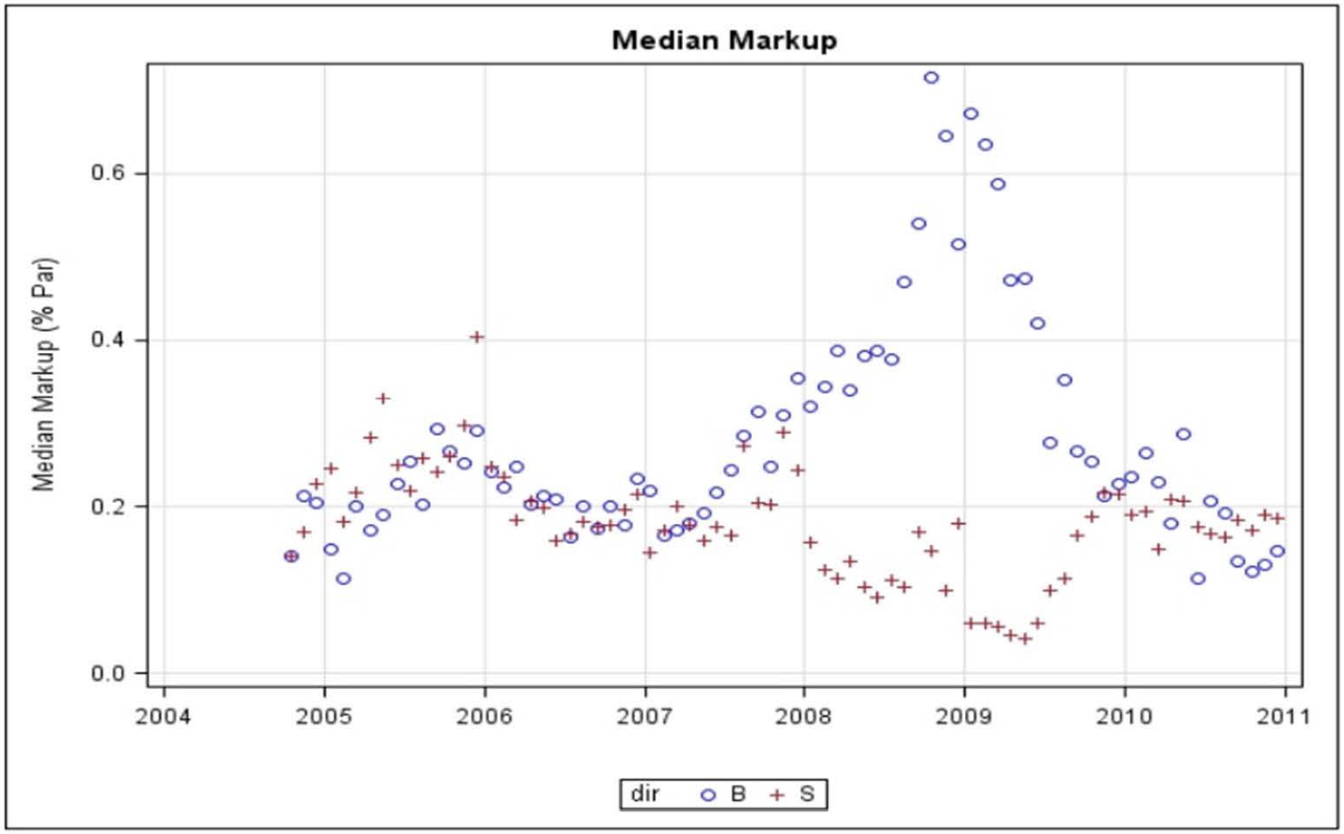


Figure 3: **markup over time.** This plot shows the time series of the median "markup", as a percentage of par, when the dealer is buying from a customer (circle) and when selling to a customer (cross). The markup is defined as the difference between a customer-dealer price and the inter-dealer price. The bid-ask spread is then the sum of the markup to buy and the markup to sell. In the financial crisis of 2007-09, as dealers sought to reduce their inventory, they priced bonds low to encourage customers to buy from them, and discourage them to sell to them. We see this effect by higher markups when dealers were buying, and lower when they were selling.

Source: O. Randall (2013). Pricing and liquidity in the U.S. corporate bond market., available at http://people.stern.nyu.edu/orandall/pdfs/paper_Oliver_Randall.pdf. Note: data computed from TRACE.

<u>Back to Reality (1 of 2)</u>

- The <u>intent</u> of the VR is to eliminate covered entities' proprietary trading & the risks that arise from that trading
  - "a banking entity <u>shall not</u> engage in proprietary trading" (Sec. 13(a)(1)(A))
- There are certain, specified, narrow "permitted activities"
  - But, the <u>intent</u> of the rule is <u>not</u> to, for example, maximize a covered entity's ability to market make or hedge or serve anything they call a "client"

Back to Reality (2 of 2)

- In implementing the prohibition and the permitted activities, the method that <u>accomplishes both</u> is required rather than subordinating one to the other
  - Prop trading is banned, but the specified market making and risk mitigating hedging, for example, are permitted
    - Both can be done without prop trading
- That's what <u>all but</u> the biggest banks do: they don't have the balance sheet/capital access

What regulators and market participants need in the VR: clear, enforceable rules of the road

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But, regulators' attempts to satisfy industry & provide clarity have resulted in confusion & contradiction in the proposed VR

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Worse, the regulatory system set up in the proposed <u>rule requires regulators to find needles in haystacks</u>

- But, it won’t work: there are too many, extremely sophisticated, highly motivated and richly rewarded “needle hiders”

And, there are too many haystacks (banks, trading units, desks, traders, etc.) plus more haystacks created by the metrics themselves

Giving yourself an impossible task; you will not find the needles & are doomed to fail

The predictable, foreseeable future

- No clear rules of the road, prop trading unfound hiding in haystacks blowing up, investors harmed, public outcry & regulators being blamed

<u>The Solution</u>: break the link between prop trading & banker bonuses

1. Limit all compensation to fees, commissions and observable bid/ask spread

2. Large, swift penalties on execs, supervisions, traders, etc.

<u>AND</u>

3. Require market makers to lay off or hedge their positions and run a flat book

4. Require high correlation, congruence for all risk mitigating hedging

The Result: Clear, workable, enforceable boundaries for market participants and regulators

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The proposed rule purports to, but fails to set boundaries for <u>market making</u>

– Market making revenue “primarily” from bid/ask spread
– Profits consistent and volatility low under “normal” market conditions
– Compensation “designed not to reward proprietary risk taking”
– Proposed metrics are a morass making all this worse
  • Detailed in comment letters (esp. 4/16/12)

And, the proposed rule purports to, but fails to set boundaries for <u>risk mitigating hedging</u>

– Purchase or sale of covered position
  - Meets internal control standards
  - Mitigates one or more specific risks
  - “Reasonably correlated” with risks to be hedged
  - Doesn’t create significant new unhedged exposures
  - Subject to continuing review
  - Compensation “designed not to reward proprietary risk-taking”

The proposed boundaries will not work, will invite regulatory arbitrage, will result in prop risks

- What is <u>“Market making”</u>?
  - What is “(1) reasonably expected (2) near term (3) demands of (4) clients, customers or counterparties”?
  - When is revenue “designed” to be “primarily” from bid/ask, etc.?
  - When is a comp arrangement “designed not to reward proprietary risk-taking”
  - Can compensation include capital gain/arbitrage profits if it is ostensibly not the “design”?
    - If so, ultimate form over substance, defeating entire rule

Same problems re hedging:

- <u>"Risk mitigating hedging"</u>?
  - What is a "reasonable level of correlation"?
  - When is "inception"?
  - What is "significant exposures"?
  - What is "mitigation" of said "significant exposure"?
  - Again, what are "compensation arrangements" that are "designed not to reward propriety risk taking"?
    - Again, focus on "design" is the ultimate form over substance, defeating entire rule

Regulatory arbitrage is likely because incentives are wrong

- When “market makers” or “hedgers” share in capital gains/arbitrage profits, they have strong reason to rationalize in-the-money positions as
  - “intended to meet expected customer demand”
  - the result of “unexpected market volatility”
  - “reasonably correlated” with a hedged position under “prevailing industry standards”
- Regulation and enforcement then takes place, <u>ex post facto</u>, on very difficult, ambiguous legal terrain = nightmare

The VR must prevent covert prop trading <u>due to "hide and disguise" strategy</u>

- "The banks have no intention of ceasing their prop trading. They are merely <u>disguising</u> the activity, <u>by</u> giving it <u>some other name</u>."

  "Wall Street Proprietary Trading Goes Under Cover," Michael Lewis Bloomberg, Oct. 27, 2010

- What other name? "Market making" and "risk mitigating hedging"

Trader/Bank Evasion Will Be Rampant

- "One trader … said that from here on out, if he wants to take a proprietary position in a credit, he will argue that he bought the position because a customer wanted to sell the position, and he was providing liquidity"
  - "To keep the trade on, he would merely offer the bonds 10 basis points higher than the offered side, so that he will in effect never get lifted out of the position, while being able to say that he is offering the bonds for sale to clients, but no one wants 'em."
  - "When the trade finally gets to where he wants it – i.e., either realizing full profit, or slaughtered by losses – he will then sell it on the bid side and move on."
- "There are a hundred different ways to claim to be acting as an agent or for a customer." Id.

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Bloomberg

Secret Goldman Team Sidesteps Volcker After Blankfein Vow

By Max Abelson - Jan 8, 2013

Sitting onstage in Washington's Ronald Reagan Building in July, Lloyd C. Blankfein said Goldman Sachs Group Inc. (GS) had stopped using its own money to make bets on the bank's behalf.

"We shut off that activity," the chief executive officer told more than 400 people at a lunch organized by the Economic Club of Washington, D.C., slicing the air with his hand. The bank no longer had proprietary traders who "just put on risks that they wanted" and didn't interact with clients, he said.

That may come as a surprise to people working in a secretive Goldman Sachs group called Multi-Strategy Investing, or MSI. It wagers about $1 billion of the New York-based firm's own funds on the stocks and bonds of companies, including a mortgage servicer and a cement producer, according to interviews with more than 20 people who worked for and with the group, some as recently as last year. The unit, headed by two 1999 Princeton University classmates, has no clients, the people said.

The team's survival shows how Goldman Sachs has worked around regulations curbing proprietary bets at banks. Former Federal Reserve Chairman Paul A. Volcker singled out the company in 2009, saying it shouldn't get taxpayer support if it focuses on trading. A section of the 2010 Dodd-Frank Act known as the Volcker rule, drafted to prevent banks from taking on excess risk, lim s shor erm inve ents ma ith firm

The incentives & rewards must change

- Rewards from prop trading are irresistible: bonuses & wealth beyond imagination

- **<u>If this isn't changed, nothing will change</u>**

How to align incentives with the goal of the Volcker Rule: eliminate prop pay

- Restricting the sources of income for "market makers" and "hedgers" to **fees, commissions, and observable bid/ask spread**
  - Prevents traders from participating in capital gains/arbitrage profits
  - Preserves incentives for efficient market making and hedging

How to align incentives with the goal of the Volcker Rule: eliminate prop revenues

- Require market makers to lay off or hedge their positions and run a flat book
  - What most market makers do today
- Require actual high correlation, congruent hedges for all risk mitigating hedging
  - Also what most actual hedgers do today
  - With computers, hedges and hedge equivalents are a routine, highly developed, nearly standardized science

Limits on revenue/trader compensation make the rules clear <u>and</u> enforceable

- Revenue & compensation data are readily available and easy to interpret
  - Proprietary traders are in it for their share of capital gains/arbitrage profits
  - Internal accounting of this revenue/income is detailed and precise
  - Nothing is more carefully tracked than the <u>**bonus pool**</u>: regulators must use it

Finally, large penalties are essential

- Given that the bonus rewards of prop trading are irresistible, the deterrent of swift, certain and substantial penalties are essential
  - Directed at executives, supervisors, risk/compliance/legal, traders and, where appropriate, Board members
- Must be many multiples of any gains or losses plus personal fines, time out bars, injunctions, etc.
- Cannot just say/assume regulators will rely on enforcement mechanisms elsewhere in the law
  - Trying to affect trader etc. calculations
  - Must clearly state in the rule itself
    - See 2/13/12 Comment Letter for more info

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The Current Proposed Rule: Confusion and contradiction that will serve no one

The Solution

- Limit all compensation to fees, commission and observable bid/ask spreads
- Require market makers to lay off or hedge their positions and run a flat book
- Require high correlation & congruence for all risk mitigating hedging
- Large, swift penalties on execs, supervisions, traders, etc.
  - All can be done with very few changes in the proposed rule

The result: clear, enforceable rules of the road for market participants & regulators